

Kentucky Workers' Compensation Funding Commission Investment Policy Statement

I. Kentucky Workers' Compensation Funding Commission

The Kentucky Workers' Compensation Funding Commission (KWCFC) adopted an informal Statement of Investment Policy in 1988 (and last updated 10/21/04) which has been revised to reflect current goals and objectives.

The purpose of the statement is to formalize the Board's investment objectives, policies, and procedures, to establish guidelines for the investment of the assets of the Fund, and to define the duties and responsibilities of the various entities involved in the investment process.

The major elements of the Statement are:

- Acting in a fiduciary capacity, members of the Commission will exercise that degree of judgment, skill, and care under the circumstances then prevailing which persons of prudence, discretion, and intelligence, who are familiar with such matters, exercise in the management of their own affairs in investment matters;
- The Fund's overall investment objective is to provide a Total Rate of Return, over full economic cycles, which exceeds the return of the diversified market portfolio within each asset class. The Commission seeks to meet this objective within acceptable risk parameters through adherence to a policy of diversification of investments;
- The Commission contracts with highly qualified investment advisors and counselors to provide expert, professional judgment in all investment decisions;
- Guidelines are established for each category of assets used by the Fund's investment advisors to provide a framework for monitoring quality, diversification, and liquidity;
- An annual Investment Plan will be prepared to control the allocation of funds during the year among investment advisors and categories of assets; and
- All records of investment transactions are available, for public inspection at the offices of the Kentucky Workers' Compensation Funding Commission.

II. Investment Policy

The members of the Commission, employees of the Commission, and agents thereof stand in a fiduciary relationship to the members of the system regarding the investment and disbursement of any of the assets of the Fund. In exercising this fiduciary responsibility, the Commission is governed by the "prudent man" rule which requires the exercise of that degree of judgment and care under the circumstances then prevailing which persons of prudence, discretion, and intelligence, who are familiar with such matters

exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the funds considering the probable safety of their capital.

Within this framework and the constraints on the making of investments under applicable state law, the Commission seeks to optimize the total return on the Fund's portfolio through a policy of diversified investments to achieve maximum rates of return within a parameter of prudent risk, as measured on the total portfolio.

III. Investment Objectives

To assure an adequate accumulation of reserves in the Fund at the least cost to the citizens of the Commonwealth and to provide some protection against the erosion of principal by inflation, the investment objectives over full economic cycles are:

Total Fund

- A. Achieve and maintain the Kentucky Workers' Compensation Fund balance in excess of the Accrued Benefit Liability in the Special Fund.
- B. Achieve a Total Return that exceeds the Balanced Index, comprised of 50% S&P 500 Stock Index and 50% of the Lehman Brothers Government/Credit Bond Index, net of investment management fees.
- C. The performance objectives for each manager's portfolio shall be as follows:

Equity Managers

- 1. The total return shall exceed the relevant equity market benchmark net of investment management fees for the following investment styles:

Large Cap Core	–	S&P 500 Index, or Russell 1000
Large Cap Value	–	Russell 1000 Value, or S&P Barra Value
Large Cap Growth	–	Russell 1000 Growth, or S&P Barra Growth
Mid Cap Value	–	Russell Mid Cap Value, or S&P Midcap Value
Mid Cap Growth	–	Russell Mid Cap Growth, or S&P Midcap Growth
Small Cap Value	–	Russell 2000 Value, or S&P 600 Value
Small Cap Growth	–	Russell 2000 Growth, or

International – MSCI EAFE

2. The investment manager is expected to rank in the top 50% versus other managers with a similar investment style (i.e., large cap value, small cap growth, etc.).
3. The investment manager will be expected to maintain acceptable volatility (standard deviation or beta) relative to their respective benchmark and will be expected to maintain a positive risk adjusted performance (alpha).

Fixed Income Managers

1. The total return shall exceed the total return of the Lehman Brothers Government/Credit Bond Index net of investment management fee.
 2. The investment manager will be evaluated versus a Fixed Income Manager Universe and will be expected to rank in the top 50%.
 3. The investment manager will be expected to maintain acceptable volatility (standard deviation or beta) relative to their respective benchmark and will be expected to maintain a positive risk adjusted performance (alpha).
 4. The duration shall fall within 20% of the duration of the benchmark index.
- D. For the short-term fixed income manager, achieve in Short-Term Securities relative performance better than the return on U.S. Treasury Bills (90 days).

Total return includes income and both realized and unrealized gains and losses and is computed on market value.

The Commission seeks to meet these objectives within acceptable risk parameters (as defined by beta) through adherence to a policy of diversification of investments by type, industry and investment manager style. In addition, investments are selected in accordance with quality guidelines contained in Section IV of this Statement.

IV. Investment Guidelines

The Investment Advisor

The KWCFC, pursuant to KRS 342.1223 subsection (4) will appoint the Office of Financial Management and Economic Analysis (OFMEA) as the KWCFC's Investment Advisor. The KWCFC will utilize the advice and expertise of OFMEA in the management of its investment funds. IF OFMEA is unable to provide such advice and expertise, the Commission may contract for investment advisor services pursuant to the provisions of KRS Chapter 45A.

The duties of the Investment Advisor are as follows:

- a. Advising KWCFC in current economic matters and events that affect KWCFC;
- b. Aid KWCFC in the selection and evaluation of independent money managers;
- c. Aid KWCFC in the formulation of new investment policies and procedures;
- d. Recommend to KWCFC new asset allocations for the various asset classes as market conditions dictate;
- e. Present to KWCFC, at regularly scheduled meetings, an investment summary detailing relevant information regarding the investment of the Commission's funds;
- f. Coordinate the efforts of all investment managers;
- g. Other duties as assigned by the KWCFC;

The Investment Managers

- a. The investment manager(s) will certify that it has no conflict of interest with the KWCFC.
- b. The investment managers will submit monthly and quarterly performance reports to the KWCFC. The Manager will be available for on site visits with the KWCFC as requested.
- c. The investment managers understand that the safety and accountability of the KWCFC's funds are of extreme importance. Therefore, all funds managed shall be maintained in separate identifiable accounts in the name of the KWCFC.
- d. The investment managers will ensure prudent diversification within proposed guidelines.
- e. The investment manager shall maintain compliance with Asset Allocation specifications established in the Asset Allocation section of this Investment Policy.
- f. No financial instrument will be purchased or held in bearer form, other than cash.
- h. The investment managers agree to all other provisions of the KRS 342.1223, KRS 342.1227 and KRS 386.030.
- i. The investment managers are expected to communicate, in writing, any developments that may impact the assets of the Commission. Examples of these events include, but are not limited to:
 - Significant change in investment philosophy
 - Loss of one or more key management personnel
 - Assignment of a new portfolio manager to the Commission
 - Change in the ownership structure of the investment management firm

- Any occurrence which might potentially impact the management, professionalism, integrity or financial position of the investment management firm

Goals

The primary goals of the fund will be safety of principal, liquidity, and achievement of the highest possible total return.

- a. **Safety:** Safety must be assured by full compliance with all appropriate statutes, regulations, and policies. Safety shall also be achieved through the limitation of risks through target allocations, diversification within those allocation groups, credit limitations, and through the selection of competent investment managers.
- b. **Liquidity:** Liquidity requirements to meet the KWCFC obligations must be identified and planned for in the investment allocation process. The Commission will give a reasonable notice to the investment managers of the liquidity requirements.
- c. **Total Return:** After meeting the aforementioned goals, the investment managers will be charged with generating the highest possible net return on the Commission's assets given policy guidelines.

Authorized Investments

- a. The short-term investment manager will be limited to investments authorized under KRS 42.500 and 200 KAR, Chapter 14.
- b. The fixed income investment managers will be limited to the following types of investments:
 1. United States Treasury securities, agencies, and other obligations backed by the full faith and credit of the United States Government. The definition of agencies is considered to be broad based, including those securities of agencies and corporations whom are considered to be instrumentalities of the United States Government. No limit on dollar amount or as a percentage of the portfolio.
 - a) U.S. Government and U.S. Government Agency guaranteed mortgage pools, including GNMA, Federal Home Loan Mortgage Corp. and FNMA instruments.
 2. Bank Certificates of Deposit rated A or better by a recognized rating service. Limited to a maximum of 5 percent of a bank's capital structure. Limited to no more than 5 percent of total fund assets.
 3. Domestic (United States) and foreign corporate obligations if the obligation is rated investment grade by a recognized rating service at the time of purchase. In the event of a subsequent downgrade to below investment grade, the manager shall use professional judgment in the decision to sell or retain the downgraded security. The manager shall also notify the investment committee of the board, in writing, of the reasons for the retention if that is the decision.

4. Banker's Acceptances which are originated by a bank rated in one of the top three rating categories by a recognized rating service. Limited to 10 percent of fund assets with no more than 2½ percent of fund assets in a single issue at time of purchase.
 5. The combined total of Banker's Acceptances and Commercial Paper will not exceed 10 percent of total fund assets.
 6. Repurchase Agreements, which must be governed by a Public Securities Association Master Repurchase Agreement (similar in structure to the Commonwealth of Kentucky's). These agreements shall be collateralized at 102 percent (marked to market daily) with U.S. Treasuries and agencies.
 7. Money Market accounts and Mutual Funds as approved by the KWCFC.
 8. Investments not subject to KRS 342.1227.
 9. Other investments as approved by the KWCFC.
- c. The equity managers shall adhere to the guidelines outlined below:
1. For diversification purposes, the equity portfolio(s) of each investment manager will hold at least 20 positions.
 2. Each investment manager must assure that no position, or combination of positions, of any one issuer shall exceed 12% of the manager's portfolio at cost or 15% at market.
 3. There shall be no purchase which would cause a position in the portfolio to equal or exceed 5% of the issue outstanding.
- d. The KWCFC desires to lend its U.S. Treasury and agency securities in a securities lending program with a primary dealer. The lending of these securities should be in substantial conformance with the Commonwealth of Kentucky's Securities Lending Program.
- e. Investment instruments specifically not allowed:
- There shall be no investments in non-marketable securities.
 - The investment managers shall not utilize derivative securities to increase the actual or potential risk posture of the Kentucky Workers' Compensation Funding Commission. Subject to other provisions in this Investment Policy Statement, the use of primary derivatives, including, but not limited to, Structured Notes, lower class tranches of Collateralized Mortgage Obligations (CMO's), Principal Only (PO) or Interest Only (IO) Strips, Inverse Floating Securities, Futures Contracts, options, short sales, margin trading and such other specialized investment activity is prohibited.

Moreover, the investment managers are precluded from using derivatives to effect a leveraged portfolio structure (if options and futures are specifically approved by the Commission, such positions must be offset in their entirety by corresponding cash or securities).

The Commission must explicitly authorize the use of such derivative instruments, and shall consider certain criteria including, but not limited to, the following:

- i. Manager's proven expertise in such category.
- ii. Value added by engaging in derivatives.
- iii. Liquidity of instruments.
- iv. Actively traded by major exchanges (or for over-the-counter positions, executed with major dealers).
- v. Managers internal procedures to evaluate derivatives, such as scenario and volatility analysis and duration constraints.

Any of the above investments which are not allowed by KRS 386.030 shall not be utilized and are not acceptable to the KWCFC.

Short-Term Investment Manager

One hundred percent of funds are to be invested with maturities of two years or less in the type and limits as specified in the KRS 42.500, 200 KAR Chapter 14, and the Investment Program Procedures Manual of the Office of Financial Management and Economic Analysis. Liquidity of the Fund's assets is of prime importance in the short-term investment fund.

Asset Allocation **(Market Value)**

<u>Type of Securities</u>	<u>Total Fund</u>		<u>Managers</u>		
	<u>Target</u>	<u>Range</u>	<u>Equity</u>	<u>Fixed Income</u>	<u>Balanced</u>
Equities:			80%-100%	-	10-30%
Large-Cap Domestic	35%	25%-45%	-	-	-
Equities:					
Small-Mid Cap	15%	10%-20%	-	-	-
International		0%-10%	-	-	-
Fixed Income	50%	40%-60%	-	75%-100%	70%-90%
Cash		0-10%	0-20%	0-25%	0-20%

V. Investment Protection Principles

The following Investment Protection Principles (the "Principles") incorporate practices and procedures designed to promote objective securities research and analyst independence by firms that provide investment-banking services by:

- 1) *severing any link between compensation for firms' research analysts and their investment-banking business;*
- 2) *prohibiting investment-banking input into analyst compensation;*
- 3) *creating a review committee at each firm to approve all research recommendations;*
- 4) *requiring that upon discontinuation of research coverage of a company, firms will disclose the coverage termination and the rationale for such termination;*
- 5) *disclosing in research reports whether the firm has received or is entitled to receive any compensation from a covered company for work performed during the past 12 months; and*
- 6) *establishing a monitoring process to ensure compliance with the Principles.*

Adoption and enforcement by firms providing investment-banking services of policies implementing the practices and procedures set forth herein is an integral part of the Principles.

Acknowledge by:

Investment Manager

KWCFC

_____Winslow_G._Hale_____
_____Executive_Director_____